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TAX REFORM AND THE VOLUME LIMITATIONS PLACED UPON LOW-INCOME HOUSING CREDITS AND TAX EXEMPT BOND AUTHORITY

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TAX REFORM AND THE VOLUME LIMITATIONS PLACED UPON LOW-INCOME HOUSING CREDITS AND TAX EXEMPT BOND AUTHORITY

ABSTRACT

The Tax Reform Act of 1986 has set limitations upon the amount of tax exempt bonds that may be issued within each state where the bond proceeds are used by private organizations. The Act also limits the amount of low-income housing tax credits that may be claimed in each state in each year. The allocation of these tax benefits is, largely, left up to the state. Boston should take steps to encourage the adoption of an allocation system which (a.) allocates these tax benefits according to need rather than population as Boston has a disproportionate need relative to other cities and (b.) gives to Boston the ability to use the benefits in a manner that attracts investment to projects selected by the city rather using the benefits only on developments initiated by the developers.

INTRODUCTION

The Tax Reforms Act of 1986 overhauled virtually every area of federal income taxation. This act, which was recently passed into law, has changed a great many details with regard to the calculation of various tax benefits for such areas of investment as housing and industrial development. Tax benefits are provisions within the federal income tax code which exempt from taxation certain forms of private investment. Rather than subsidize these investments directly through expenditure of public funds, the federal government has chosen to subsidize them indirectly through the non-collection of taxes on these projects. It has been

a procedure that has been used widely throughout the country to encourage investment in various types of residential, commercial and industrial development.

Tax reform has, however, gone beyond making alterations to the methods of calculation and has implemented measures to make these tax benefits a scarce resource. Areas of public and private investment that previously received tax benefits automatically by simply meeting the requirements of the income tax code, must meet many, often more stringent, requirements and must successfully compete against other qualified proposals for the limited supply of tax benefits. Receiving tax benefits will no longer be automatic for many categories of development. Tax benefits will be limited in amount and must be rationed by either state or local levels of government among eligible projects.

Two types of tax subsidy that will be particularly hard hit by this new system will be the use of tax exempt financing for projects not owned and operated by a unit of government and privately owned housing which sets aside some or all units for occupancy by low- or moderate-income households.

LIMITS ON TAX EXEMPT FINANCING

The most important aspect of the new limitations on tax exempt financing is that it has not changed the tax exemption upon ordinary state and local bond issues. If

bonds are issued to finance traditional functions of state and local government, then the interest paid to investors on these bonds will continue to be exempt from federal income tax. As long as the development financed by the bonds is owned and operated by a unit of state or local government, then the bonds continue to be exempt from taxation. This provision, of course, makes it possible for state and local government to issue bonds paying a lower interest rate than would otherwise be possible.

The target of the tax reform act is the use of state and local bonds for developments owned or operated by private entities. Over the last several years, it has become commonplace for a governmental agency to issue bonds under the name of the state but to pass the bond proceeds on to a private, non-governmental person or company for specified uses. This has made it possible for private developers to obtain low-cost financing for such projects as industrial parks and multi-family housing and for such normally private sector activities as providing mortgage backed loans for single family housing. In these cases, the state or local level of government simply acts as an intermediary. The government borrows from private investors through issuing bonds. The investors enjoy tax exemptions on the interest income that they receive. The government takes the bond proceeds and loans it to private developers at an interest rate only slightly above the government's

borrowing rate so as to cover the costs of issuing the bonds.

In the report by the Joint Committee on Taxation of Congress, it is clear that they believe the uses of this tax exempt financing have exceeded the purposes for which the tax provision was designed. In order to retain these forms of tax benefits but force the uses of them to better serve public sector goals, the tax reform act will severely limit the dollar amount of tax benefits that may be used in each state in each year.

Private Activity Bonds. This form of government bond issue is referred to in the tax reform act as private activity bonds. These bonds are defined as any government bond issue which:

1. a. Provides 10 percent or more of the bond proceeds for use by private persons other than a unit of state or local government,

and

b. Direct or indirect payment of the debt service (principle and interest) by private persons is equal to or greater than 10 percent of the total debt service payment,

or

2. Loans made from the bond proceeds to private persons exceeds the lessor of 5 percent of the bond proceeds or $5 million.

This type of governmental bond issue is taxable under the new tax reform act.

Exceptions to the Taxation of Private Activity Bonds. The tax reform act provides for several exceptions to the new rule. These exceptions will continue to enjoy a tax exempt status even though they will be categorized as private activity bonds. These include:

A. Several previously tax exempt uses. All bonds issued to finance the activities of 501(c)(3) non-profit organizations will continue to exempt. Transportation facilities (airports, docks, wharves and commuter developments) and utilities (water, sewer and gas) will still be exempt. In addition, bonds used to fund student loan pools will continue to be exempt.

B. Residential rental projects. If the bond proceeds are used to finance residential developments that are continuously occupied low-income households eligible to the special income tax credits (discussed later), the bonds will be tax exempt. In Massachusetts, this includes the bonds issued by the Massachusetts Housing Finance Agency for housing under the SHARP program and the bonds issued by the Boston Housing Authority under the TELLER program. C. Mortgage revenue bonds. For a limited time, bonds issued to fund loans for single-family home purchases will be exempt. However, this exemption will expire on December 31, 1988. Further, the federal government is encouraging the

exchange of this form of tax benefit to tax credits at an exchange rate of 25 percent.

D. Small issue redevelopment bonds. Small issue redevelopment bonds for manufacturing uses will be exempt until the end of 1989. Small issue bonds for non-manufacturing uses will be taxable after 1987.

LIMITS ON LOW-INCOME HOUSING TAX CREDITS

The tax reform act severely reduced the tax benefits available to investment in real estate. Accelerated depreciation, lower tax rates on capital gains income and the use of paper losses from investment in real estate to shelter income from other sources have all been reduced or eliminated. However, to encourage investment in housing for low-income households, the tax reform act provides for tax credits based upon the value of this type of investment.

These tax credits may be claimed each year for a period of 10 years. The housing units against which they are claimed must be occupied by low-income households for a period of 15 years. For any units to be eligible for a credit, at least 20 percent of the units in the total development must be occupied by households with incomes below 50 percent of the metropolitan area's median or at least 40 percent must be occupied by households below 60 percent of the median. The tax credits are based upon the non-land value of the investment only. These credits are:

A. 4 percent of the acquisition cost of existing housing,

B. 9 percent of the cost of developing new housing or rehabilitating existing housing if privately financed,

C. 4 percent of the cost of developing new housing or rehabilitating existing housing if financed through tax exempt bonds.

In the past, tax benefits applied to all real estate development without limitation. Special benefits were available to certain real estate developments, but all could obtain tax benefits simply by generating the investment. The above tax credits will not necessarily be available to all eligible developments. The development must be allocated a share of the state's allotment of tax credits.

THE CAPS UPON THE USE OF TAX EXEMPT BONDS AND TAX CREDITS

The tax reform act places a dollar limit upon the amount of tax exempt bonds that may be issued for the exempt private activity bonds and upon the amount of tax credits that may be claimed within each state. The limitations are separate for each state and allocated to each state rather than a national volume cap with a competition for the resource as has been used in many urban development programs. The allocation of the state's credits and bond authority is left up to the state.

Bond Authority Caps. The amount of the exempt bonds that may be issued by each state is set at the greater of $75 per

resident or $250 million for 1987. After 1987, the cap will be set at $50 per resident or $150 million per year. Most states already exceed these caps by a significant amount. Thus, the caps are low relative to current usage and will require significant cuts.

Tax Credit Caps. The tax reform act provides for a state limitation of $1.25 per resident on the volume of low-income housing tax credits. At least 10 percent of the state volume must be set aside for non-profit organizations. Note that this tax credit cap does not include credits given to housing financed through the issue of tax exempt bonds. As these bonds come under the volume cap of tax exempt bond issue, credits for that housing does not count against the state's low-income housing credit allocation. Each years allocation must be used during the current year. No carry forward of unused credits from one year to later years will be permitted. Thus, if the credits go unused during any one year, they are lost to the state. In addition, these credits may be allocated only to projects placed in service during the year. This means that the allocation of the 1987 tax credits will effectively be limited to projects already now planned and being constructed. With the nationwide slow down in multi-family housing activity, the problem with the 1987 credit allocation may be finding projects ready to claim the credits rather than distributing the credits over competing projects.

DISTRIBUTION OF THE VOLUME CAP WITHIN EACH STATE

The tax reform act gives the power of rationing the bond authority and tax credit caps to each state. The state has broad discretion in the allocation of the benefits to various state and local government and to individual projects.

For the tax exempt bonds issued under the rules and specified exceptions, the state must allocate the total state bond authority over the various state and local units of government. To cover the immediately pending bond issues, the Governor of each state must determine the system of allocation. This interim authority granted to the governor expires at the end of the year in which the state legislature next comes into session and adopts an allocation plan. If the legislature fails to adopt a plan, the governor's interim authority expires and a federal allocation system becomes the rule by default. The federal system provides for simple allocation of the total state volume according to the population within the jurisdiction of the unit of government.

For the low-income housing credits, the allocation is made by the State's housing agency. This agency, presumably the Executive office of Housing and Community Development, will administer the allocation unless a specific plan is established by the Governor or legislature.

POLICY ISSUES FOR BOSTON

The City of Boston should take steps to ensure that it receives its fair share of these tax benefits. If the allocation systems adopted by the state for bond authority or EOCD for tax credits do not make special provisions for the degree of need within each municipality, the allocations could penalize Boston. An allocation of bonding authority based upon the jurisdiction's population could grant scarce resources to communities that have very little need for or interest in developing eligible projects. Allocation of these tax benefits to these communities may result in the benefits going unused. Allocation of tax credits by EOCD to individual developments may result in the credits being used on those development most readily available rather than those serving the most needy population. Because of the complexity of Boston's housing needs and the special difficulties of developing projects within the central city, it is easier to develop projects outside Boston. As such, EOCD may be tempted to allocate credits to projects as they come forward and petition for these benefits. Developers may tend to pursue the least difficult projects which will be located outside of Boston.

These conditions could place Boston at a competitive disadvantage in the search for tax benefits for projects located within Boston. This suggests that Boston should seek two adjustments in the system of allocating these scared resources:

1. That some consideration of need be imposed upon the system of bond authority allocation. Rather than per capita allocation, a system based upon the population below poverty or the population unemployed may prove to be a superior system of allocation. This would tend to direct more bond authority to those localities, including Boston, where the benefits of tax exempt financing will better serve a needy population.

2. That tax credits be allocated according to housing need. Rather than give the credits out among competing projects as they come forward, the credits be allocated to communities according to their need for low-income housing. These credits could be used as inducements to attract developers to projects programmed by the communities rather than being allocated to projects initiated by the developers.